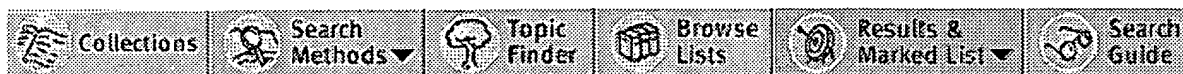


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Instability of equilibria in experimental markets: Upward-sloping demands, externalities, and fad-like incentives

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Markets in which the value of the activity to any one person increases with the level with which the activity is undertaken by others are studied. The general interpretation could be fads, mimicking behavior, or some sort of belief formation process in which the beliefs or expectations of agents about some underlying state of nature are influenced by the buying behavior of other agents. The result is to create a market that can be modeled as having an upward-sloping market demand curve. The questions posed are: 1. In the fad-like environment, does the classical concept of equilibrium accurately predict market behavior? 2. Can both stable and unstable equilibria be observed? 3. Which of the 2 classical concepts of stability best describes the conditions under which instability is observed?

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The objective of the paper is to study markets in which the value of the activity to any one person increases with the level with which the activity is undertaken by others. The general interpretation could be fads, mimicking behavior, or some sort of belief

formation process in which the beliefs or expectations of agents about some underlying state of nature are influenced by the buying behavior of other agents. The result is to create a market that can be modeled as having an upward-sloping market demand curve. The questions posed are (i) in the fad-like environment, does the classical concept of equilibrium (as an equating of market demand and market supply) accurately predict market behavior; (ii) can both stable and unstable equilibria be observed; and (iii) which of the two classical concepts of stability best describes the conditions under which instability is observed? Under the conditions of a fad-like demand side externality in a market organized by the multiple unit double auction (MUDA), market equilibration occurs at a point where demand equals supply. The disequilibrium behavior follows the dynamics of the Marshallian model of dynamics, as opposed to the Walrasian model. These results confirm and extend the major findings of Plott and George who studied a similar environment with a downward-sloping supply.

1. Introduction

This paper addresses four questions: (i) Can an upward-sloping demand be successfully created in a laboratory environment through the introduction of an externality, similar to fadlike preferences? (ii) In the presence of such special characteristics, do markets equilibrate to the classical intersection of the demand and supply curves? (iii) Can both stable and unstable equilibria be observed? This is a rather deep question since it asks if markets obey laws of dynamics similar to those that have been observed in physics. (iv) If markets do exhibit instability, which of the two classical concepts of stability, Marshallian stability or Walrasian stability, does the best job of predicting the conditions under which instability will be observed? Both of these theories are based on very general models of market behavior and so should apply to the simple and special case of an experimental setting. Indeed, the theories should apply to an experimental setting with the same force that would be applied to any other setting. Thus, experimental methods are a perfect way to address the issues, especially when no alternative method seems to exist.

The questions posed are natural. First, a fundamental part of neoclassical theory of market adjustments resides in the presumption that markets can be unstable. Thus, there is a natural intellectual curiosity about whether or not the presumption is correct. Second, there is a practical motivation for an interest in stability. Multiple equilibria often appear in models, causing difficulty with model specification. The conventional solution to the problem is to discard the equilibria that are unstable under the presumption that unstable equilibria cannot be observed, that is, they are removed from all consideration. It is only natural to ask if this convention is justified. The third question stems from an issue about the relationship between the competitive model of markets and game theory. The most basic principles of economics are being replaced by principles of game theory and related solution concepts. Do phenomena exist in markets that will be very difficult if not impossible to capture with the static solution concepts of game theory? In particular, game theory and the associated concepts of solutions tend to be equilibrium theories, without any accompanying notion of dynamics or equilibration. Thus, since disequilibrium is a primary feature of instability, it is a rather obvious place to look for challenges to the static equilibrium concepts of game theory.

Notice that the motivations for this study are essentially unrelated to parameters that might be found in the U.S. economy, or any other economy, for that matter. The motivations are not about the economy; they are about economics and the underlying principles of economics that we use as tools to understand the economy. At this stage, the investigation is strictly of a laboratory nature. While the study suggests many interesting questions about the nature of markets found in the field, they are not addressed here. For example, the question of the relative frequency or instances of instability are not addressed. Measures that might indicate when a market is perched at an unstable equilibrium are not sought. This study is about the nature of the laws that govern whether or not an equilibrium is stable, and the focus is on the behavior of markets in the laboratory.

Once one decides to look for instability, the neoclassical theory itself suggests where to search. According to the ideas, the curves must have a perverse shape in the sense that the demand curve should slope upward or the supply curve should slope downward. Neoclassical theory also suggests two types of underlying economic circumstances that can produce such perversities. One set of circumstances is related to income effects. Both the famous Giffen good of upward-sloping demands and the labor-leisure tradeoff that produces backward-bending (downward-sloping) supply curves are related to the income effect. A second set of circumstances is related to externalities or external economies, as Marshall called them. On the supply side, downward-sloping supplies are thought to be produced by efficiencies that might be produced by expanding industrial scale. On the demand side, a similarly constituted externality can produce the upward-sloping demand curves that are thought to be produced by preferences such as desires to mimic the behavior of others.

This paper employs the second set of circumstances, the use of externalities to create an upward-sloping demand. Markets were created in which the value of the units to any one person increased with the level with which the units are purchased by others. The more others do it, the more any particular individual wanted to do it. The general interpretation could be preferences that result in a desire to mimic others or it could be some sort of belief formation process in which the beliefs or expectations of agents about some underlying state of nature are influenced by the buying behavior of other agents. The result of the preference inducement was to create a

market that can be modeled as having an upward-sloping market demand curve even though individual demand curves are downward sloping. With such a demand, an opportunity arose to observe whether or not instability presents itself.

Based on previous research, a presumption exists that Marshallian stability and not Walrasian stability will be observed. Plott and George (1992) studied markets in which the supply was downward sloping due to a Marshallian externality and found that the Marshallian model of market stability provided the appropriate conditions under which instability could be observed. The Walrasian concept of stability was found to be completely inappropriate for that type of economic environment. Since an upward-sloping demand is a mirror image of the Marshallian downward-sloping supply, the current study is a test of both the replicability and the robustness of the Plott and George experimental results.

The results are easy to summarize. Unstable equilibria can exist in markets. They exist at the intersection of demand and supply, as do other classical market equilibria. Where the perverse curves are due to an externality, the Marshallian model and not the Walrasian model define the conditions under which unstable equilibria exist. The experiments replicate and extend the results previously reported by Plott and George.

Aside from classical discussions, the literature about the possibility of upward-sloping demands is not extensive. Papers by Becker (1991) and Karni and Levin (1994) both addressed issues of fad-like preferences. (For brevity, we will refer to them as B&KL.) Interestingly enough, both sets of authors, B&KL, failed to realize that they were dealing with a classical Marshallian external economy on the demand side as opposed to the supply side. After translation to the demand side, the model of B&KL differs from Marshall and Plott and George (1992) (PG) in only two substantive respects. The first is the structure of the externality and the second is the assumed industrial organization.

First, with respect to the structure of the externality, B&KL do not require that the level of market activity be the vehicle that carries the externality, as do Marshall and PG. Instead, B&KL fads allow market demand to be the vehicle of the externality independent of whether or not the demand resulted in trades or whether adequate supply exists. By contrast, the formal representation of the externality used in PG depends on actual volume traded in the market (Marshallian fads). In B&KL fads, the utilities of agents depended on the number of people that want to do something rather than the incidence of them actually doing it, as is the case in Marshall fads and in PG.

Second, with respect to the industrial organization, B&KL assume that there are only a small number of well-informed sellers and many myopic buyers. By contrast, Marshall and PG assume that there is symmetry between the buying and selling sides of the market. The implications of these differences are rather dramatic. Marshall and PG apply the competitive model on the one hand and with it can characterize notions of stable and unstable markets together with possible dynamic adjustment processes. By contrast, B&KL allow the demand side to behave much like competitors, from which a demand function can be derived in the same way that it is derived in this paper. However, that is where the similarity ends. In this paper, the supply is also derived by application of the competitive model. In B&KL, the sellers are fully informed of the behavior of the demand side of the market and are able to solve for various equilibria using standard game theoretic logic. The problem posed by B&KL is then one of selecting the appropriate equilibrium by appeal to solution concepts.

While both sets of authors, B&KL, mention stability, they do not use the term in a classical sense. In fact, it is interesting to note that, to the extent that the term stability makes sense, they identify instability with Walras and not Marshall. Thus, as the data reported in this paper show, the intuitive ideas of instability that they apply are exactly the opposite of what they should use.

The organization of the paper is as follows. Section 2 is a review of the two competing models of market adjustment, Marshallian and Walrasian. This section is also used to introduce the major features of the experimental design. Sections 3 and 4 are brief summaries of the formal structure of the externality model and the associated concepts of demand and equilibrium from the point of view of the individual and the market, respectively. Section 5 is a discussion of the market supply functions. Section 6 is an outline of the experimental design and the predictions of the models, given the parameters imposed. Section 7 discusses experimental procedures. Section 8 contains the experimental results. The final section is a summary of the conclusions. An appendix contains forms and instructions.

2. Marshall, Walras, and the Experimental Strategy

Suppose the market is characterized by an upward-sloping demand such as drawn in Figure 1, D,D1. This is only a crude approximation of the actual parameters that were induced in the experiment. Exactly how they were

induced will be described in later sections. For now, the curve will be used to describe the difference between the Walrasian and the Marshallian models of market adjustment.² Consider also the upward-sloping supply curve S, S' . There are four potential equilibria, points a, b, c, and d. In addition, the actual intersection of the curves is not the behavioral intersection because of a transaction cost that is always observed in markets. Units for which there are exactly no gains from trade will not trade. Thus, a small gap exists between demand and supply at equilibrium.

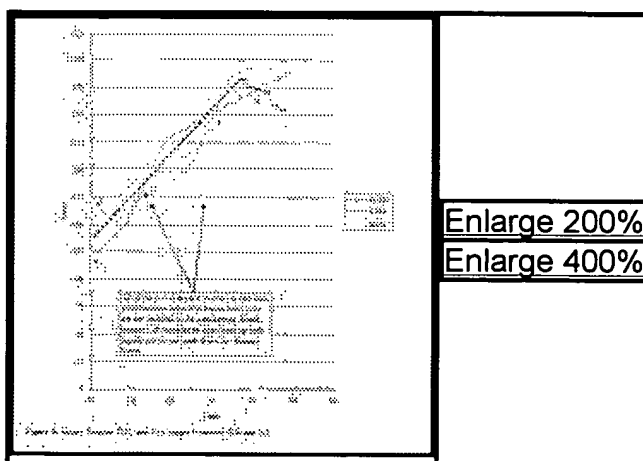
Walras: $\dot{p}(t) = F(D(p) - S(p))$	Enlarge 200%
Marshall: $\dot{q}(t) = G(P_D(q) - P_S(q))$	Enlarge 400%

Let $D(p)$ and $S(p)$ be the quantities demanded and supplied at a particular price and let $P_D(q)$ and $P_S(q)$ be the demand price and supply price, respectively, at some quantity q . The two models of adjustment are So the Walrasian model postulates that price adjusts with a speed dictated by the difference between quantity demanded and quantity supplied at the price. The theory is silent about quantity. The Marshallian model postulates that quantity adjusts with a speed dictated by the difference between the demand price and the supply price evaluated at the quantity. The theory is silent about price. Both theories were developed on special "as if" assumptions about the nature of the adjustment process. For example, Marshall assumed a special trading in which the high valued and low cost units trade in sequence. Walras assumed the market was a tatonnement system. These assumptions allow the theories of dynamics to proceed by observing only one of the variables (price or quantity) while neglecting the other. Of course, the derivative of both F and G is positive.

The substantial difference between the theories can be seen in Figure 1. Under supply conditions S, S' point b is stable according to the Marshallian model but is unstable under the Walrasian model, that is, if the price moves slightly upward, away from b, then according to the Walrasian model, demand is greater than supply so price continues to go up. On the other hand, if quantity increases slightly beyond point b, then according to the Marshallian model, the supply price is greater than demand price and the quantity will fall back to b. Point a is unstable under the Marshallian model, but it is stable according to Walras. Point c is Walras stable and Marshallian unstable. Point d is stable according to both models. Thus, the models give essentially opposite behavioral predictions.

Now, consider the supply curve S_2S_2' . Points a', b, and c are equilibria. However, now the stability properties are reversed. Point b is stable according to the Walrasian model (a' and c are unstable) while point b is unstable according to Marshall (a' and c are stable). Again, the models give essentially opposite behavioral predictions.

The single demand curve D, D' , shown in Figure 1, and the two supply curves demonstrate the logic of the experimental design. By beginning with S, S' parameters, it is possible to discover whether or not the system moves toward one of the several equilibria. If it does, then we will know that the equilibrium of the demand and supply model captures market tendencies and the first two questions will be answered. Then, after the market equilibrates, a supply shift to S_2S_2' will make the equilibrium unstable according to the dynamics of the model that got it there, if indeed such laws of dynamics are operative. An equilibrium that was previously stable, presumably, has now become unstable. If the market then moves away from the equilibrium to which it had previously converged, then we have answers to questions iii and iv.



Figure

A possibility exists that market activity will stay at an unstable equilibrium because it is never perturbed away far enough to cause the underlying instability to become operative. After the shift in supply function, the market activity could simply stay at the equilibrium even though it has become unstable. To deal with this possibility the experimental design called for a push to the market. The dynamic model theoretically requires only a small push, but since we have no theory of what might be small, the plan called for something rather dramatic. If, after the shift, the market did not move, the demand would be shifted to D2D2 in Figure 2. The method of accomplishing this will be discussed in later sections. Briefly summarized, the trick was to allow each subject to operate "as if" the volume of others was at least 15 units; that is, even if the volume of others was less than 15, the subject's payoff was made as if the volume of others was 15. If volume of others was more than 15, then the subject's payment was based on the actual volume. As will be made clear below, the incentives were conditioned on the volume of others (an externality), and the resulting guarantee produced a normal downward-sloping demand up to 15 units of others because there was no externality. Beyond 15, the externality existed so the upward-sloping character was again present. Figure 2 displays D2D2 in the presence of the supply curve S2S2 because this was the supply condition during the only time that the change in parameters was deployed. Under conditions S2S2 and D2D2, the only equilibrium is c, which is stable according to Marshallian principles of dynamics but is unstable according to Walrasian principles of dynamics.

3. Underlying Theory of Demand and Individual Incentives

The upward-sloping demand curve is the result of an externality. Each individual buyer makes decisions about one's own consumption based on prices and based on expectations about the decisions of others. In terms of the general theory, this relationship is captured by a utility function of the form $U(x_i, x_i)$, where x_i is own consumption and x_i is the consumption of others. Since the consumption of others may not be known at the time of decision, a distinction is made between x_i and $x_{e i}$, where $x_{e i}$ represents the beliefs of i about the consumption activities of others. Of course, the beliefs could be represented by a probability distribution, but for purposes of these theories, the decision under uncertainty takes a very specialized form.

$x_{e i} = x_{e i} = \sum_{j \neq i} x_j$	Enlarge 200% Enlarge 400%
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In a competitive model, each individual attempts to maximize $U(x_i, x_{-i})$ by choosing x_i subject to the budget constraint and the beliefs about the activities of others. Given the special forms of beliefs, the problem becomes an attempt to maximize $U(x_i, x_e)$ subject to the budget constraint. As will be made clear in subsequent discussions, the equilibrium of the system will be defined by a rational expectations axiom that requires that all expectations about the behavior of others are accurate; that is, in equilibrium, the rational expectations requirement will be that

$x_{e i} = x_{e i} = \sum_{j \neq i} x_j$	Enlarge 200% Enlarge 400%
$x_{e i} = x_{e i} = \sum_{j \neq i} x_j$	Enlarge 200% Enlarge 400%

From an experimental design perspective, the most complicated aspect of individual incentives is the determination of redemption values for buyers because of the externality and resulting fad-like incentives. As any one agent buys more, the marginal value of units to other agents increases. The models of the experimental situation assume that agents prefer more money to less and that money is the only thing that the agents care about; that is, where m_i is the amount of money earned by the subject in a given period of the experiment, the incentives on which the model is based are captured by the function $U_i(m_i)$. If the individual faces a competitive market price P , then the money income of agent i is of the form

Equation 3 is the basis of the incentive charts for buyers contained in the appendix. The experiment employed three different agent buyer types, and there were two subjects for each type. All buyers had identical parameters b and c , with $b = 16$ and $c = 8$. The a_i parameter differed according to type, with the value of a E 132, 136, 140. In the table, the units of m are in francs and each franc is converted at a rate of 0.24 dollars per franc for buyers and 0.01 dollars per franc for sellers.

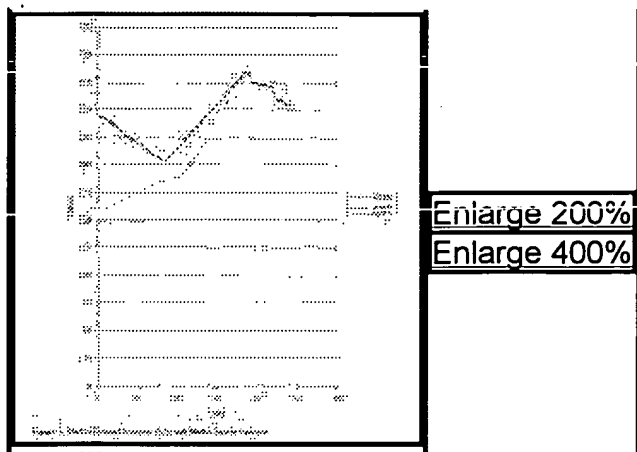
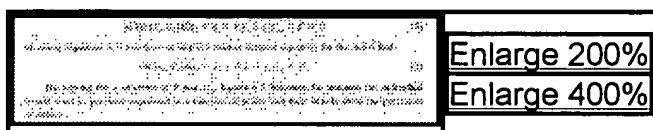


Figure 2.

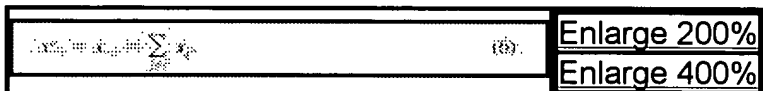
An approximation of this function is shown in Figure 3 for individual 0. Shown here are the marginal redemption values for various units given that the volume of others is 5, 10, 15, and 20, respectively. As can be seen, the redemption values for the individual decrease as units purchased increase, given that the purchases of others are constant. However, if purchases of others go up, then the marginal values for this individual go up. Shown also in the figure is the market demand for this individual. It will be explained in the next section.

4. Underlying Theory of Demand and Market Parameters



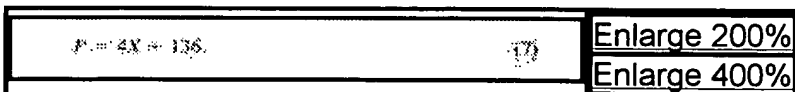
Since all buyers and sellers were in essence given interest-free loans for the duration of a period, they have no budget constraint. In this case, the maximization hypothesis dictates that the buyers will behave as if they were attempting to satisfy the equation $dU(mi(x_i, x_e;))/dx_i = 0$. Since utility is assumed to be monotone in money earnings, the hypothesis is that the individual attempts to maximize money income given the beliefs about the transactions of others; that is, the variable x_i is replaced by a different variable x_e ; in the model of the individual's decisions. From Equations 1, 2, and the hypothesis about beliefs, this becomes

Figure 3 contains a graph of the demand function implicit in Equation 5 for individual 0, given beliefs about the transactions of others. If the other individuals purchase five units and if the price is 155 francs, then this individual would want to purchase one unit. If the price was 179 francs and if others purchased 10 units, then this individual would want to purchase 2 units. If the price was 203 francs and if others purchased 15 units, then this individual would want to purchase 3 units. Thus, one can obtain an intuition of how a market demand might have an upward slope if increasing prices were associated with more purchases by others.



The simultaneous relationship between prices and purchases of others is used by the competitive model to produce the upward-sloping demand. The theory requires that, for a price and quantity to be an equilibrium on the demand side of the market, each individual is optimizing given the price; that is, Equation 5 must be satisfied for each individual. Second, the theory requires that the expected sales of others equals the actual sales. No buyer is surprised by what other buyers do. This is a type of rational expectations axiom. In particular

Equation 5 is the vehicle that ties expected transactions to the actual transactions of the individual. Equation 6 ties the beliefs of the individual about the behavior of others to the actual behavior of others. Specifically, it requires that the beliefs are accurate.



Substituting the parameters for the experiment and solving the resulting expressions of Equations 5 and 6 yields a continuous approximation of market demand. The calculations for both D_1D_1 and D_2D_2 are shown in Table 1. For example, for D_1D_1 the parameters are 132, 136, 140 for the values of a_i for each of the types. There are two agents of each type yielding a total of six agents on the demand side. The values of b and c are the same for all agents and are, respectively, 16 and 8. Substituting and solving the resulting market demand function thus derived is approximately

Notice that the demand function has a positive slope. The computations in the table differ slightly due to the discrete nature of the units that compose the table.

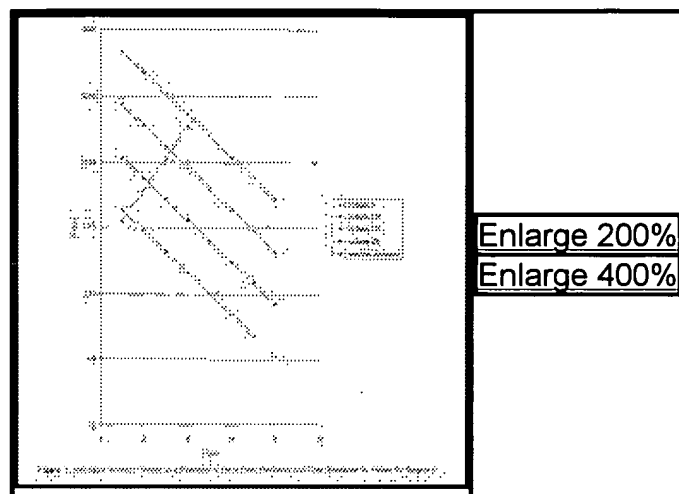


Figure 3.

5. Market Supply

Parameters supporting two different supply functions are utilized in the experiments. These are seen as S_1S_1 and S_2S_2 in Figure 1. The numerical parameters are contained in Table 1. These curves were induced using standard procedures. An example of a seller's cost sheet is contained in the appendix. As will be explained in the next section, these two different supply functions imply different stability properties when market demand is D_1D_1 .

6. Experimental Design and Model Predictions

The experimental design called for the market to first contain the demand parameters D_1D_1 and the supply parameters S_1S_1 . These parameters were to stay in place for period 0 through period 8. Pilots and previous experiments suggested that this was sufficient time to give the system an opportunity to equilibrate at one of the several equilibria. In period 9, the supply curve was shifted to S_2 . The demand curve would remain unchanged at D_1D_1 , and the supply shift would be implemented in a manner that was undetected by the demand side of the market. The effect of this shift in supply would be to reverse the stability properties of all of the equilibria according to both theories. Thus, all stable equilibria according to a given theory would become unstable according to that theory and all unstable equilibria would become stable (with some exceptions at the extreme boundaries). Thus, if markets have elements of the dynamics captured by either of the two theories, then prices and quantities would move away from the equilibrium to which they had previously converged, and this to and fro behavior would isolate the nature of the dynamics involved. If no movement took place, if the prices and quantities remained at a possible unstable equilibrium, then the design called for the implementation of demand curve D_2D_2 . This shift in demand would provide a push that could further test the dynamics.

The equilibria under the various conditions are listed in Table 2. As can be seen, with the exception of the outermost equilibrium under conditions S_1S_1 , all equilibria have opposing stability properties depending on the theory applied. And, after the supply shift, the stability properties are reversed.

7. Experimental Procedures

A total of three experiments was conducted plus pilot experiments. These are indexed by the dates on which the experiments were conducted (021592, 022292, and 030292). Subjects were students at the California Institute of Technology who were recruited for the experiment and were told that they would be paid. The instructions were

read to the subjects. Afterward, the markets were opened through a computerized market in the Caltech Laboratory for Experimental Economics and Political Science. All markets were organized as computerized multiple unit double auctions (MUDA), as described in Plott (1991). Subjects were trained to use the computer in electronic markets through the software tutorial programs contained in the general MUDA package. The incentive charts were organized such that it is reasonable to assume that the fact that the market demand function was stationary over all periods was public information. The incentive charts of suppliers were such that the supply curve shift could not have been detected by the demand side of the market until it was possibly revealed through the behavior of the market itself.⁴

Period	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60	61	62	63	64	65	66	67	68	69	70	71	72	73	74	75	76	77	78	79	80	81	82	83	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99	100	101	102	103	104	105	106	107	108	109	110	111	112	113	114	115	116	117	118	119	120	121	122	123	124	125	126	127	128	129	130	131	132	133	134	135	136	137	138	139	140	141	142	143	144	145	146	147	148	149	150	151	152	153	154	155	156	157	158	159	160	161	162	163	164	165	166	167	168	169	170	171	172	173	174	175	176	177	178	179	180	181	182	183	184	185	186	187	188	189	190	191	192	193	194	195	196	197	198	199	200	201	202	203	204	205	206	207	208	209	210	211	212	213	214	215	216	217	218	219	220	221	222	223	224	225	226	227	228	229	230	231	232	233	234	235	236	237	238	239	240	241	242	243	244	245	246	247	248	249	250	251	252	253	254	255	256	257	258	259	260	261	262	263	264	265	266	267	268	269	270	271	272	273	274	275	276	277	278	279	280	281	282	283	284	285	286	287	288	289	290	291	292	293	294	295	296	297	298	299	300	301	302	303	304	305	306	307	308	309	310	311	312	313	314	315	316	317	318	319	320	321	322	323	324	325	326	327	328	329	330	331	332	333	334	335	336	337	338	339	340	341	342	343	344	345	346	347	348	349	350	351	352	353	354	355	356	357	358	359	360	361	362	363	364	365	366	367	368	369	370	371	372	373	374	375	376	377	378	379	380	381	382	383	384	385	386	387	388	389	390	391	392	393	394	395	396	397	398	399	400	401	402	403	404	405	406	407	408	409	410	411	412	413	414	415	416	417	418	419	420	421	422	423	424	425	426	427	428	429	430	431	432	433	434	435	436	437	438	439	440	441	442	443	444	445	446	447	448	449	450	451	452	453	454	455	456	457	458	459	460	461	462	463	464	465	466	467	468	469	470	471	472	473	474	475	476	477	478	479	480	481	482	483	484	485	486	487	488	489	490	491	492	493	494	495	496	497	498	499	500	501	502	503	504	505	506	507	508	509	510	511	512	513	514	515	516	517	518	519	520	521	522	523	524	525	526	527	528	529	530	531	532	533	534	535	536	537	538	539	540	541	542	543	544	545	546	547	548	549	550	551	552	553	554	555	556	557	558	559	560	561	562	563	564	565	566	567	568	569	570	571	572	573	574	575	576	577	578	579	580	581	582	583	584	585	586	587	588	589	590	591	592	593	594	595	596	597	598	599	600	601	602	603	604	605	606	607	608	609	610	611	612	613	614	615	616	617	618	619	620	621	622	623	624	625	626	627	628	629	630	631	632	633	634	635	636	637	638	639	640	641	642	643	644	645	646	647	648	649	650	651	652	653	654	655	656	657	658	659	660	661	662	663	664	665	666	667	668	669	670	671	672	673	674	675	676	677	678	679	680	681	682	683	684	685	686	687	688	689	690	691	692	693	694	695	696	697	698	699	700	701	702	703	704	705	706	707	708	709	710	711	712	713	714	715	716	717	718	719	720	721	722	723	724	725	726	727	728	729	730	731	732	733	734	735	736	737	738	739	740	741	742	743	744	745	746	747	748	749	750	751	752	753	754	755	756	757	758	759	760	761	762	763	764	765	766	767	768	769	770	771	772	773	774	775	776	777	778	779	780	781	782	783	784	785	786	787	788	789	790	791	792	793	794	795	796	797	798	799	800	801	802	803	804	805	806	807	808	809	810	811	812	813	814	815	816	817	818	819	820	821	822	823	824	825	826	827	828	829	830	831	832	833	834	835	836	837	838	839	840	841	842	843	844	845	846	847	848	849	850	851	852	853	854	855	856	857	858	859	860	861	862	863	864	865	866	867	868	869	870	871	872	873	874	875	876	877	878	879	880	881	882	883	884	885	886	887	888	889	890	891	892	893	894	895	896	897	898	899	900	901	902	903	904	905	906	907	908	909	910	911	912	913	914	915	916	917	918	919	920	921	922	923	924	925	926	927	928	929	930	931	932	933	934	935	936	937	938	939	940	941	942	943	944	945	946	947	948	949	950	951	952	953	954	955	956	957	958	959	960	961	962	963	964	965	966	967	968	969	970	971	972	973	974	975	976	977	978	979	980	981	982	983	984	985	986	987	988	989	990	991	992	993	994	995	996	997	998	999	1000	1001	1002	1003	1004	1005	1006	1007	1008	1009	1010	1011	1012	1013	1014	1015	1016	1017	1018	1019	1020	1021	1022	1023	1024	1025	1026	1027	1028	1029	1030	1031	1032	1033	1034	1035	1036	1037	1038	1039	1040	1041	1042	1043	1044	1045	1046	1047	1048	1049	1050	1051	1052	1053	1054	1055	1056	1057	1058	1059	1060	1061	1062	1063	1064	1065	1066	1067	1068	1069	1070	1071	1072	1073	1074	1075	1076	1077	1078	1079	1080	1081	1082	1083	1084	1085	1086	1087	1088	1089	1090	1091	1092	1093	1094	1095	1096	1097	1098	1099	1100	1101	1102	1103	1104	1105	1106	1107	1108	1109	1110	1111	1112	1113	1114	1115	1116	1117	1118	1119	1120	1121	1122	1123	1124	1125	1126	1127	1128	1129	1130	1131	1132	1133	1134	1135	1136	1137	1138	1139	1140	1141	1142	1143	1144	1145	1146	1147	1148	1149	1150	1151	1152	1153	1154	1155	1156	1157	1158	1159	1160	1161	1162	1163	1164	1165	1166	1167	1168	1169	1170	1171	1172	1173	1174	1175	1176	1177	1178	1179	1180	1181	1182	1183	1184	1185	1186	1187	1188	1189	1190	1191	1192	1193	1194	1195	1196	1197	1198	1199	1200	1201	1202	1203	1204	1205	1206	1207	1208	1209	1210	1211	1212	1213	1214	1215	1216	1217	1218	1219	122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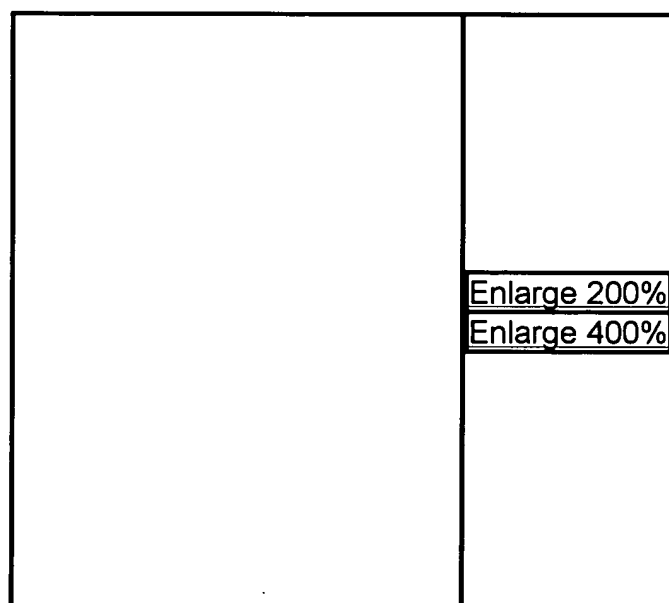
Experiment 030292. Periods 0 through 8, supply S,S, was operative; periods 9 through 18, supply S2 was operative.

The different period structure of experiment 021592 reflected the misunderstanding by one subject seller. This seller thought that selling all units listed on the incentive sheet was necessary. Theoretically, this would be interpreted as a substantial shift to the right of S,S, that moves all interior equilibria to the right. Of course, during the first periods, the high volume (e.g., 40 units) was noticed by the experimenters. However, the possibility that a subject might be confused was not really considered by the experimenters at first. Instead, the experimenters thought that the market had found the stable equilibrium that exists at the point (40, 273). This particular equilibrium would have been very costly to the experimenters, and a decision was made to save money and eliminate periods 6 and 7. If the market was resting at that equilibrium, little was to be learned by letting it continue through the entire planned periods. The subjects were told that, due to a computer problem, periods 6 and 7 would be opened and then immediately closed without trade and that the subjects should simply mark out those periods on the incentive charts. They were told that the experiment would resume at period 8. Period 8 was chosen because it is one period before the parameter shift to the S2 supply curve. While periods 6 and 7 were being opened and closed, a spot check of subject records revealed the confused subject. Thus, before the beginning of period 8, the confusion was discovered and the subject was told that it was not necessary to sell everything. After this, the experiment proceeded as planned. Of course, all subjects had learned from the market in the first several periods that the market could sustain a high volume. In particular, the buyers, who did not know of the supply shift, were aware of the possibility.

8. Results

The time series from all three experiments are displayed in Figures 4-6. Shown on the horizontal axis is time in seconds. The vertical axis is price. The circles represent contracts. The vertical lines are the divisions between periods. The horizontal lines are the most important equilibria. The bottom of the figures contain average prices per period and volumes.

The central conclusion summarized by the two formal result statements is that Marshallian stability, as opposed to Walrasian, is the appropriate model for environments like the one under study. The results are supported by the visual representation of the data. The time series from the two central experiments (022292 and 030292) are contained in Figures 4 and 5. In both experiments under S,S" the time series reveals the convergence to the nearest stable Marshallian equilibrium point at (176, 12). This equilibrium is Walrasian unstable, but it is Marshallian stable. The supply shift S2S2 that occurs in period 9 of both experiments is accompanied by a movement away from the old equilibrium (which is now Walrasian stable) toward one of the two neighboring stable Marshallian (unstable Walrasian) equilibria. In experiment 022292, the convergence is downward toward point a' at (154, 0), and in 030292, the convergence is upward toward point c at (248, 30). The data from experiment 021592 are in Figure 6. When the model is adjusted for the mistake of the seller at the first part of this experiment, a Marshallian stable equilibrium appears near point c. As can be seen, the data are converging toward this area. After shifts, the data fall away from the uppermost stable Marshallian equilibrium, through the stable Walrasian equilibrium, to the lower stable Marshallian equilibrium. Then the data return to the upper stable Marshallian equilibrium.



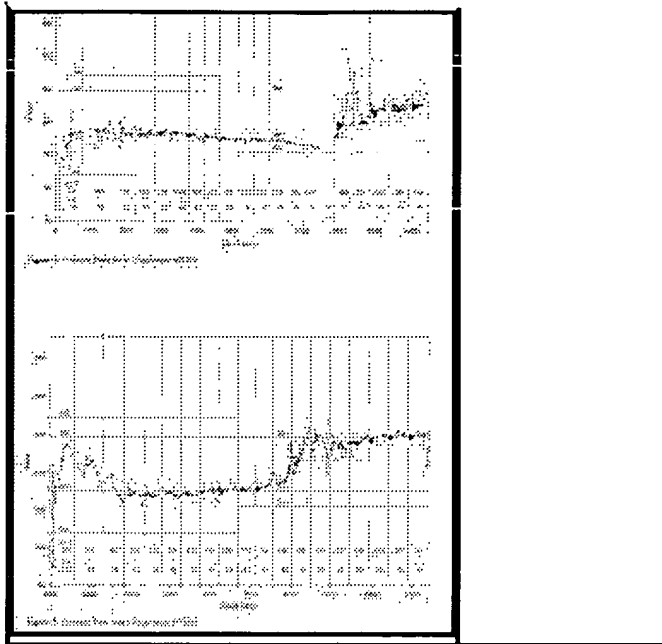


Figure 4.
Figure 5.

RESULT 1. The law of supply and demand accurately predicts points of equilibration.

SUPPORT. In both of the central experiments (022292) and (030292) under supply SiS, before a parameter shift (periods 0 through 8), the time series reveals the convergence to the nearest stable Marshallian (and unstable Walrasian) equilibrium point b at (176, 12). In experiment 022292, the volume is within 2 units of the equilibrium volume of 12 units for the periods 2 through 8 and the average price is within 8 francs (less than 5%) of the equilibrium price of 176 for periods 1 through 8 and within 3 francs (less than 2%) for periods 6, 7, and 8. In experiment 030292, the volume is within 2 units of the equilibrium volume of 12 units for periods 1 through 8 and the average price is within 5 francs (less than 3%) of 176 for periods 2 through 8 and within 1 franc (less than 1%) for periods 7 and 8.

After the supply shift to S2S2, the data in all three experiments converge toward one of the neighboring stable Marshallian (unstable Walrasian) equilibria. In experiment 022292, by period 13, the average price and volume are (167, 3), and by period 14, the volume is zero, which is near the equilibrium point a' at (154, 0). After the demand shifts to D2D2, the data converge toward the equilibrium c at (248, 30). For the final three periods, the volume is within one unit and the average price is within 11%. During the final three periods of experiment 030292, the volume is within one unit and the average price is within 2% of the equilibrium point c.

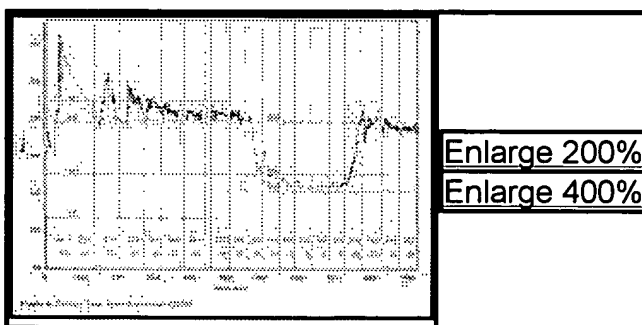


Figure 6.

In experiment 021592, after the subject's misunderstanding was corrected, the volume is within two units for the final four periods, 16, 17, 18, and 19. The average price is within 5% of the equilibrium point c at (248, 30). QED.

The next conclusion is that the Marshallian model, and not the Walrasian model, captures the nature of the equilibration process; that is, the dynamics are Marshallian and not Walrasian since the convergence is toward the Marshallian stable equilibrium points.

RESULT 2. Price and quantity movements are in the direction predicted by the Marshallian model and not in the direction predicted by the Walrasian model.

SUPPORT. Table 3 contains the estimates of the two dynamic models for experiments 022292 and 030292. Estimates for experiments 022292 and 030292 are calculated separately for different sets of parameters. In Table 3, the estimate term for the Marshallian model bM is always positive. It is significant (95% confidence interval) for both 022292 and 030292. Thus, the data support the Marshallian model. Contrary to prediction of the Walrasian dynamic model, the adjustment term bw is negative for both 022292 and 030292. It is significant for both data sets. Thus, the Walrasian model can be rejected in favor of the Marshallian model. Pooled data yield even stronger support for the result. QED.

The support for the Marshallian model is not all positive. The model predicts zero intercept

aM . However, as can be seen from Table 3, aM is systematically negative and significant (95% confidence interval for 022292). The next observations might help account for the inaccuracies.

The image shows a screenshot of a table with multiple columns and rows of data. The table is titled 'Table 3' and contains estimates for two experiments, 022292 and 030292. The columns include parameters like aM , bM , bw , and cM . The rows show the estimates for each experiment. A large button overlay on the right side of the table reads 'Enlarge 200%' and 'Enlarge 400%'.

Table 3.

OBSERVATION. The dynamics of price adjustment have a memory. Information in the adjustment process is not simply local information of the recent past.

SUPPORT. The support for this observation comes from experiment 021592 in which a subject was confused for the first few periods. Notice in Figure 6 that the data start with high prices and volume due to the implicit change in parameters of the one supplier. This change, in essence, creates a stable equilibrium until period 8, when the confusion was removed. It is interesting to note that, during period 8, the market is resting at an unstable Marshallian equilibrium. When the shift occurs at period 9, the equilibrium becomes Marshallian stable and, during period 9, the market stays near the equilibrium. However, in order to get to the high-priced equilibrium, the market must move away from the stable Marshallian equilibrium of zero volume that exists at point a' on the boundary. The high-priced stable equilibrium is not sustained. A few data points that are movements away from the stable Marshallian equilibrium take the systems into the unstable ranges. The fall in prices and volume that occurs in periods 10, 11, and 12 represents general movements toward the Marshallian stable boundary equilibrium. Of course, the fact that any volume exists at all during these periods is in defiance of the dynamic pressures of the Marshallian model. The small volumes that occurred in periods 13 and 14, when the market price falls to the lowest levels, are due to the buying behavior of a single agent. The action of one buyer constitutes 100% of the volume in periods 12, 13, and 14. It is natural to assume that this buyer is trying to signal other buyers to get the volume up so the market volume would be like the profitable experiences during the first periods of the experiment at a volume of 30 units. The hint is then picked up by other buyers in period 15. The volume and price move through the stable Walrasian (Marshallian unstable) equilibrium at (176, 12) and continue to converge to the high level Marshallian stable equilibrium near (248, 30). QED.

This observation is particularly interesting for two reasons. First, it demonstrates that the dynamics of adjustment involve memories of a sort not captured by either the Marshallian or the Walrasian models of dynamics. Second, if game theory is to be successful, it must allow for the possibility that the selection of equilibrium can occur on either side of the market. The observation identifies a case in which the possibility of "leadership" instigated by a buyer resulted in equilibrium selection. By contrast, the literature (Becker 1991; Karni and Levin 1994) assumes that the selection in the case of fad-like preferences will come from sellers alone. It is rather interesting to note that even though these papers make solid contributions to the abstract understanding and anatomy of the economics of fad-like environments, their presumption about the market dynamics is wrong and their presumption about the application of game theory is wrong as well. Clearly, results such as those reported here are of interest to theory.

9. Closing Remarks

Markets with externalities and fad-like incentives exhibit many of the qualities predicted by the competitive law of supply and demand. Equilibria of the competitive model do a good job of capturing the points of price convergence. The power of the equilibrium model is rather surprising since the demand curve construction requires very strong assumptions along the lines of rational expectations. Nevertheless, equilibration is observed.

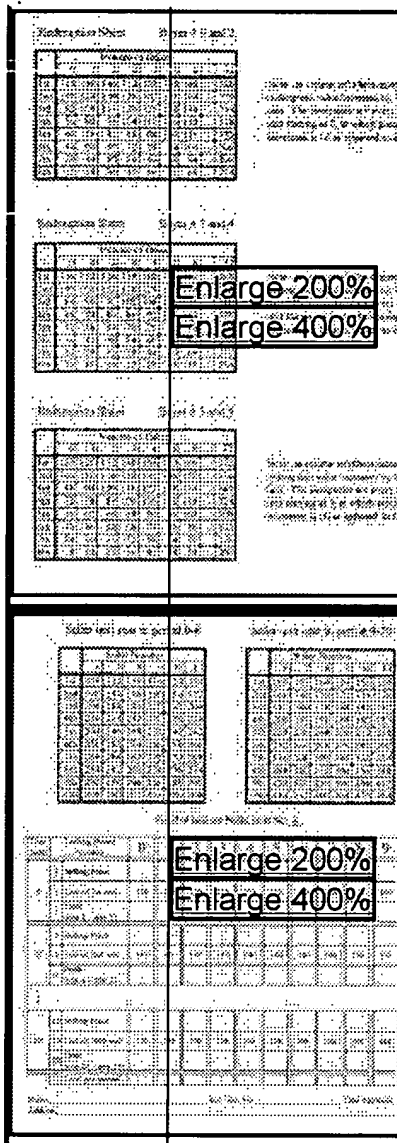
Markets with upward-sloping demands can contain both stable and unstable equilibria. If the upward slope is due to an externality like a Marshallian fad, then the conditions under which instability will be observed and the associated dynamics are best captured by the Marshallian concept of instability, as opposed to the Walrasian concept. The importance of the Marshallian concept seems to have been lost to the theoretical literature, which has focused on the Walrasian concept and on game theoretic selection models. These data suggest a need for theorists to revisit the classical Marshallian theory.

The theoretical symmetry that exists between the upward-sloping demand and the downward-sloping supply exists in behavior. The results reported here replicate the discovery of Plott and George (1992) and extend the result to the upward-sloping demand. The properties of equilibration known to exist in the downward-sloping supply case of a Marshallian external economy exist with equal strength in the upward-sloping demand case of fad-like incentives. Thus, in these environments, the competitive market law of supply and demand appears to work with the generality for which it was developed. The conditions under which instability is observed are predicted by the Marshallian model of market adjustment and not the Walrasian model. A major outstanding issue is whether or not the Marshallian theory of stability holds in the backward-bending case. At this point, there appears to be no detailed theory of the dynamics. Indeed, one might note that the Walrasian model (with the wrong sign) yields higher R2 than the Marshallian model. Thus, the door is wide open for theoretical improvements.

An error by a subject provided a glimpse at what could be one of the most important aspects of the study. The nature of market equilibrium selection is not determined by local information and dynamics alone. Collective experience, signaling through market actions, and coordinated efforts to overcome a "local" prisoner's dilemma may all play a part in the complex dynamics of equilibration.

<p>Appendix</p> <p>Table 1: Results of the experiment. The table shows the number of subjects who chose each option (A or B) in each round (1 to 10). The data is presented in a 2x10 grid.</p>	<p>Enlarge 200%</p> <p>Enlarge 400%</p>
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Appendix	
<p>Table 1: Results of the experiment. The table shows the number of subjects who chose each option (A or B) in each round (1 to 10). The data is presented in a 2x10 grid.</p>	<p>Enlarge 200%</p> <p>Enlarge 400%</p>

**[Footnote]**

¹ Experimental studies of externalities in markets have reported that the competitive model works exactly as expected. (See Plott 1983; Harrison et al. 1987.)

[Footnote]

Summaries of related ideas derived from classical and neoclassical discussions can be found in Henderson and Quandt (1980) and in Takayma (1974).

[Footnote]

3 Physically, the charts were large and no new incentive charts were passed out.

4 It was possible to shift the supply curve without new charts. The form of the charts was public information.

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